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FM AMEMBASSY NAIROBI
TO RUEHC/SECSTATE WASHDC PRIORITY 5878
INFO RUEHXR/RWANDA COLLECTIVE PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC
RUCPDOC/DEPT OF COMMERCE WASHDC
RUEHRC/DEPT OF AGRICULTURE WASHDC

UNCLAS NAIROBI 001318

DEPT FOR AF/E, AF/RSA, AF/EPS, AND EEB/IFD/OMA
DEPT ALSO PASS TO USTR FOR BILL JACKSON
DEPT ALSO PASS TO DEPT OF LABOR FOR SUDHA HALEY, PATRICK WHITE AND MAUREEN PETTIS
TREASURY FOR DAN PETERS
COMMERCE FOR BECKY ERKUL

SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN ELAB ETRD EAGR KE
SUBJECT: KENYA'S INFLATION SOARS HIGHER IN APRIL

REFS: (A) NAIROBI 1122, (B) NAIROBI 970

¶1. Summary: Overall inflation continued accelerating in April 2008, with prices an average of 26.6% higher than in April 2007 (YOY). Seasonally adjusted inflation reached 14.8%, driven mainly by food, transportation and fuel prices. The Nairobi lower income group experienced the highest inflation at 28.9% YOY, followed closely by other urban areas at 26.6%. To reduce the pressure on food prices, the GOK has decided to waive the 60% duty on up to 52,149 tons of imported wheat flour, and announced plans to import three million bags (270,000 MT) of maize by August. The Central Bank of Kenya (CBK) believes the inflation is driven by shortages and rising global energy and food prices, but is stepping up its efforts to reduce the money supply, since seasonally-adjusted underlying inflation is well over the 5% target rate. President Kibaki's decision not to mandate a minimum wage increase on May 1 means workers' buying power will continue to erode, but employers still face rising production costs and reduced sales. End Summary.

Inflation Still Accelerating

¶2. Like a vulture riding an updraft over the Rift Valley, inflation continued to spiral upwards in April from March's high levels (ref B). Overall inflation rose 26.6% year-on-year (YOY) in April 2008, the highest rate since 1994, while seasonally adjusted (average annual) overall inflation rose to a record 14.8% YOY. The underlying inflation rate, which excludes volatile food, energy and transportation prices, fell slightly to 6.5% YOY. However, the seasonally adjusted rate rose slightly to 5.6%, and both rates remained above the Central Bank of Kenya's (CBK) 5% target ceiling for money supply management.

¶3. Food, fuel and transport prices continued to drive inflation (Table 1). Food prices rose 4% from March to April (MOM), and rose 36.8% YOY in April. MOM increases for fuel and transportation slowed to under 1%, but their prices rose 15.4% and 19.5% YOY respectively. Housing costs rose 5.7% YOY. GOK officials attribute most of the inflation to rising global food and fuel prices and to supply disruptions from the post-election violence, rather than monetary factors. They acknowledge fears about high inflation are genuine, but predicted inflationary pressure would ease as the country's supply chains for goods and services are restored. However, they do not know when the local and global supply constraints will ease and inflation will decrease. Ministry of Agriculture Permanent Secretary Dr. Romano Kiome predicted food prices would escalate for the next two to three years, and Suntra Investment Bank manager Charles Ocholla said inflation rates will continue to edge upwards.

Table 1: April 2008 Overall Month on Month (MOM) and YOY Inflation,

not seasonally adjusted:

Item Group	MOM change	YOY Change
Food & Non-alcoholic drinks	4.0%	36.8%
Transport & Communication	0.4%	19.5%
Fuel & Power	0.8%	15.4%
Alcohol & Tobacco	-0.6%	14.0%
Medical Goods and Services	0.0%	7.9%
Household Goods & Services	-0.1%	7.5%
Recreation & Education	-1.0%	5.5%
Housing Costs	-0.1%	5.7%
Personal Goods	0.5%	6.2%
Clothing & Footwear	-0.2%	4.3%
Average all Groups	2.7%	26.6%

Source: National Bureau of Statistics

¶4. Lower income consumers in Nairobi, for whom food constitutes 50% or more of their purchases, remain the hardest hit, with the price of their basket of goods rising 29% in April. However, consumers in other urban areas were close behind at 26.6%.

Table 2: 2008 overall inflation YOY % Changes

Item Group	Jan	Feb	Mar	April
Nairobi Lower Income	19.9%	18.3%	23.2%	28.9%
Nairobi upper Income	9.6%	10.1%	12.5%	14.6%
Rest of Urban Centers	18.2%	20.6%	22.0%	26.6%

Source: Central Bank of Kenya (CBK).

Imported Food Should Reduce Shortages

¶5. In an effort to reduce anticipated shortages, the GOK announced it would waive the 60% duty on up to 52,149 tons of imported wheat flour, and announced plans to import three million bags (270,000 MT) of maize by August. At the end of May, the government will authorize millers and importers to ship in 17,000 MT of duty free wheat flour from COMESA partners Egypt and Mauritius. Agriculture Minister William Ruto said the government will import three million bags (270,000 MT) of maize by August to replenish the National Cereals and Produce Board's (NCPB) shrinking stockpiles and avert a major deficit before the September harvest (ref A). Minister Ruto also said the government had increased NCPB's purchase price for maize from Sh1,400/90kg bag by 21% to Sh1,700 to boost production and reserves.

CBK Struggles to Control Money Supply

¶6. The CBK is trying to tighten monetary policy to bring underlying inflation back down to 5%. The CBK relies on repurchase agreements (repos) to implement its monetary policy, but has also sold dollars several times recently through the interbank foreign exchange market to mop up more shillings and to stabilize the shilling's appreciation. In an effort to absorb more liquidity from the financial system, the CBK is experimenting with "term auction deposits" under which banks could deposit up to Sh20 million for three to 90 days in an interest earning account. The deposits would count towards meeting the CBK's liquidity ratio requirement, but could not be used as collateral to borrow from the CBK. Unlike repos and T-bills, there is no sale of a security involved.

Interest and Exchange Rates Still Not Much Affected

¶7. The raging inflation has still not affected the interest and exchange rates. During the week ending May 15, 2008, the average interbank rate was almost unchanged at 7.73%, while the repo rate to 7.39% from 6.51% the week before. Both the 91 and 182 T-bill rates declined slightly at the May 15 auction, to 7.69% and 8.76% respectively, and the average interbank interest rate stayed about 7.7%. The shilling has held stable between 61 and 62/$, and about 98/Euro. Barclays Bank official Kihara Maina said he expected the inter-bank rate would rise to 9-10% over the next six months, and that commercial lending rates would rise from the current 14% to the 16-18% range, as lenders cushion themselves against rising commodity prices. He also predicted the shilling could depreciate to as low as 67/dollar after the Safaricom IPO is completed.

Government Trying to Limit Borrowing

¶8. It appears the GOK is trying to avoid an increase in domestic borrowing that could push up interest rates and inflation. Finance Minister Amos Kimunya claimed that tax revenues hit a record high in April, were Sh8 billion above the year to date target, and that he expected Kenya Revenue Authority's 2007-08 collections would exceed the annual target. However, he admitted Kenya was also seeking Sh27 billion ($435 million) from donors to address the impact of post-election violence on key economic sectors, including food security, roads, health and water, and that he was also pushing for the sovereign Eurobond to raise funds for infrastructure and social spending.

But the Real Economy Will Feel the Effects

¶9. Frank Akoten, an economist at the Kenya Institute of Policy Analysis and Research (IPAR), warned that Kenya's rising high production costs will make Kenya's products uncompetitive in the international market, especially in COMESA, its largest market, where it competes with Egyptian and Chinese products. The manufacturing sector contributes about 10% of GDP and grew 8.3% in ¶2007. However, it is unlikely to reach that level in 2008, much less the previously predicted 10% growth. Manufacturers have frozen employment, increased their search for alternative fuels, and are introducing energy saving devices into their production lines that may also reduce labor.

¶10. At a stakeholders planning meeting on the 2008-2012, five year Medium Term Plan for implementing the Vision 2030 strategy, Minister of Planning and National Development Wycliffe Oparanya told journalists he expected 6.5% economic growth in 2008. Skeptical commentators noted the disparity with Finance Minister Amos Kimunya's growth estimate of 4-6%, and the average forecast from a Reuters poll of analysts and businessmen that growth would drop to 3.8%. Respected business journalist Robert Shaw predicted growth would drop to 2-3% and said that Minister Oparanya: "Is basically giving propaganda. He must be the only person in Kenya that believes this."

Salaries Eroding Quickly

¶11. Under GOK guidelines, workers can factor only past inflation into their wage negotiations, not anticipated inflation. Although the minimum wage of Sh5-6,000/month is not sufficient to live on, the GOK decided not to announce an increase on May 1, presumably to avoid a further increase in production costs. Therefore, the accelerating inflation will continue to erode wages and buying power for the next year or more. A recent article claimed high fuel prices are causing Nairobi drivers to start forming carpools and slug lines. Nairobi traffic was noticeably lighter in the last 10 days of May, allegedly because drivers had exhausted their fuel budget until the next paycheck.

Comment

¶12. There is no relief from inflation in sight for Kenyans, who will have to rely on their existing or new coping mechanisms to survive. The poor and middle class are tightening their belts or are simply unable to pay some bills. The GOK's program to pay tuition for all secondary students comes at a critical time for parents, but other education costs continue to rise. Low-income urban consumers must be getting food from family farms or remittances from expat Kenyans to survive, but urban and rural hunger and malnutrition is likely growing. The GOK's decision to waive the 60% duty on wheat flour imports is welcome, but long-overdue, since domestic wheat producers can supply only a small portion of demand. The planned maize imports should prevent major food shortages (if they arrive in time), but high international prices will continue driving up domestic prices. Manufacturers, service providers, farmers and exporters will be squeezed by rising input prices. Economic growth is already predicted to drop from 7% in 2007 to 4% or less in 2008, and poverty is going to increase. Kenyans faced similar conditions in the 1990s without uprisings or food riots, but the Coalition government will have to make visible and effective efforts to assist consumers and producers to minimize criticism and social unrest.